

TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: CalSTRS Investment Principals and Beliefs

ITEM NUMBER: 7

ATTACHMENT: 1

ACTION: _____

DATE OF MEETING: July 10, 2002

INFORMATION: X

PRESENTERS: Christopher J. Ailman
and Dr. John T. Por, Cortex Consulting

Executive Summary

This report will serve as an introduction to the presentation of the Investment Policy and the 2002-2003 Business Plans. At staff's request, Cortex engaged in an in-depth review and dissection of CalSTRS investment principals and beliefs. The target of this review was our policies, staff interviews, and the actual investment portfolio. The completion of this review resulted in the creation of the Statement of Investment Principles and Beliefs; an executive summary of the report is labeled as Attachment 1. The complete report will be maintained as part of staff guidelines and procedures. Dr. Por will have a brief presentation on the highlights of the project and the report.

Background

The management of any defined benefit pension plan is founded on certain basic assumptions about pension finance, the capital markets, characteristics of certain investments, and the basic investment process. These principles and beliefs are so fundamental that they are often taken for granted and seldom discussed. In fact, these principles often go unchallenged to determine if they are still appropriate. This project is an attempt to elevate, evaluate, and document these beliefs that are embedded within the CalSTRS portfolio, policies, and staff.

The investment office retained Cortex last November to conduct the study. Cortex Consulting, which is based in Toronto, Canada, has worked on several CalSTRS governance projects dating back to 1997. They have preformed this specific evaluation for the Virginia Retirement System, as well as the Wisconsin State Investment Board.

The project was conducted in phases to help reconcile one segment with the other. First, Cortex reviewed all of the CalSTRS investment policies; next they matched polices against the actual investment portfolio. Upon completion of those comparisons, Cortex then interviewed the Chief Investment Officer on all facets of the investment program, and on his investment philosophy and beliefs. Armed with this information, Cortex then interviewed each of the investment director

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individually in regards to, not only their respective asset class, but also about their broad investment belief about CalSTRS. Cortex then presented the investment staff with a comparison of the policies, portfolio, CIO views, and the view of each director.

Discussion

Staff is pleased to report that Cortex found a very common set of views within the staff. As one would expect, with any group, there were some slight differences in beliefs and viewpoints. As a result, the senior investment staff and Cortex representatives met for half a day to review, and in some cases reconcile the different views. Each of the items that raised a question for Cortex, were already on the Committee's agenda to review or resolve. These include developing a firm policy for currency management, enhancing the risk standards for the Fund, and reviewing the duration match between the fixed income assets and the liabilities.

Overall, staff feels this project was very helpful. It stimulated and challenged the core beliefs and principals that are very important, but seldom spoken of, yet they serve as the foundation of the investment program. The conclusion of this exercise is the formal statement of investment principles and beliefs. The full report will be incorporated into staff's guidelines and will be updated as needed. The value to CalSTRS is not only the reconciliation of these views with the actual investment fund, but also the permanent record of these soft issues.

The logo for Cortex Applied Research Inc. features the word "CORTEX" in a white, italicized, sans-serif font. It is positioned on the right side of a horizontal bar that has a gradient from light blue on the left to dark blue on the right.

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

EXECUTIVE SUMMARY OF THE STATEMENT OF INVESTMENT PRINCIPLES AND BELIEFS

JUNE 2002

RISK MANAGEMENT

The Retirement Fund is exposed to investment risk when it invests in capital markets. Investment risk should be managed by investing the Fund in a number of different asset classes, by establishing a long-term asset mix policy for the Fund, based on a study of the assets and liabilities of the Plan, and by implementing an investment program in which the expected volatility of return on the total assets of the Fund is at a level that is acceptable to the Retirement Board.

Investment risk may be increased through active investment management, and should be further managed by: (a) establishing a careful and disciplined process for the search and selection of investment managers; (b) setting guidelines for the regular review and evaluation of investment performance; and (b) rigorous monitoring and oversight of investment performance in compliance with these guidelines.

ASSET CLASSES

The Retirement Fund should be diversified across a broad range of asset classes including the following:

- **U.S. equities** – they provide a higher investment return than fixed income assets, and are positively correlated with growth in pension benefits.
- **Non-U.S. equities** – they provide a high investment return similar to U.S. equities, the opportunity to invest in industries and sectors not widely available in the U.S. equity market, and allow the Fund to be diversified across a number of different foreign equity markets.
- **Fixed income** – for diversification because they are less volatile and have a relatively low correlation with equities.
- **Cash and short-term securities** – for liquidity because they have very little volatility.
- **Real estate** – for diversification because they have a low correlation with stocks and bonds, and to provide some protection against inflation in the long run.
- **Alternative investments** – to provide higher returns than public equity markets, as well as diversification because of their relatively low correlation with stocks and bonds.

CalSTRS should also undertake various programs and initiatives (such as securities lending, corporate governance, credit guarantees, etc.) in order to enhance the return of the Fund.

INVESTMENT STRATEGIES

Active and Passive Management

Both active and passive investment strategies should be used in managing the Retirement Fund. Active strategies should be used in all asset classes, with passive strategies also in markets that are relatively efficient, such as U.S. and international equities in many developed economies. Where there is less potential for highly active strategies to add value, such as in fixed income markets, enhanced index or other low risk strategies should be used. All real estate and alternative investments should be actively managed.

Tactical Asset Allocation vs. Rebalancing

CalSTRS should not undertake deliberate short-term changes in the asset allocation of the Retirement Fund, but instead should strive to maintain the allocation close to the Fund's long-term asset mix policy. However, relative movements in capital markets can cause the Fund's asset allocation to drift away from the long-term asset mix policy. When the asset allocation moves outside a minimum-maximum range, it should be rebalanced to bring it back within the range. The process should be managed by internal staff, under the direction of the CIO, using its discretion and judgment with respect to the timing, speed and size of the transactions required for rebalancing.

Internal and External Management

Both internal staff and external investment managers and advisors should be involved in the management of the assets of the Retirement Fund. The majority of the assets of the Fund should be managed by external investment management firms who have the necessary resources and expertise required to run highly active strategies. Internal staff should run passive and low risk enhanced strategies in stocks and bonds. Real estate and alternative investments should be undertaken largely by external partners and managers, with internal oversight and control.

Currency Hedging

Currency risk should be managed in order to try and prevent fluctuations in exchange rates from adversely impacting the assets of the Fund.

PORTFOLIO STRUCTURE

U.S. Equities

U.S. equities should include both large and small cap stocks, with a higher proportion of small cap than the market, but no significant biases or tilts in investment style. The majority of assets should be passively managed. Investment managers should have style and/or segment specific mandates. Individual portfolios should be fully invested as far as possible without market timing.

Non-U.S. Equities

Non-U.S. equities should be diversified over all segments of the international equity market, including stocks in developed as well as emerging markets. The portfolio should be managed using both active and passive investment strategies in roughly equal proportions. Investment managers should have broad market mandates as well as regional mandates.

Fixed Income

Fixed income investments should be diversified over all available maturities instead of being restricted to long-term bonds, and should include investment-grade as well as high yield bonds.

Real Estate

Real estate investment should include traditional assets as well as some non-traditional assets, including private REITS and low-rated CMBS. It should not include raw land (unless held for future development), farmland or timber. Ownership structures may include direct investment, joint ventures, commingled funds and securitized investments.

Alternative Investments

Alternative investments should include venture capital, leveraged buyouts, equity expansion investments, mezzanine and distressed debt. It may invest in special situations in the oil and gas, banking and health care sectors, but not timber or farmland. Hedge funds could also be considered as an alternative investment but they should be managed separately. Investments should be undertaken through limited partnerships, secondary interests and co-investments.

PERFORMANCE MEASUREMENT

Total Fund Performance

The performance of the total Fund should be compared against: (a) the actuarial return in order to determine the impact of investment management on the funded position of the Plan; (b) the rate of inflation in order to determine whether the future purchasing power of the assets of the Fund is being preserved; and (c) the long-term asset mix policy in order to determine the value added by the management of the assets of the Fund.

The performance and cost of managing the Fund should also be monitored relative to other large public pension funds to determine if the Fund is earning a reasonable net investment return. However, such peer group comparison should take into consideration differences in asset mix policy, investment program, and legislation governing the various pension funds in the group.

Asset Class Performance

The performance of each asset class should be compared against either: (a) a broad market index which is representative of that asset class; or (b) if such an index is not available, a benchmark which reflects the opportunity cost of an alternative allocation of the investment in that asset class, in order to determine the value added by investment management of that asset class.

Investment Manager Performance

Equities and Bonds – The performance of investment managers should be compared against: (a) a relevant passive benchmark or index which is representative of the manager's investment mandate and style in order to determine the value added by active managers, and the "tracking error" of passive or index fund managers; and (b) a representative peer group sample of other managers to determine if the portfolio has earned a competitive rate of return.

Real Estate and Alternative Investments - The performance of investment managers, properties and commingled funds in real estate should be compared against a broad market index adjusted for risk. The performance of investment managers, limited partnerships and commingled funds in alternative investments should be compared against a representative "peer group" sample of other managers and funds to determine if they have earned a competitive rate of return.